SCS Agency
Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Sweeney | Analyst: Marion Mann DeJong | Bill Number: AB 1631

Related Bills: | Telephone: (916) 845-6979 | Amended Date: 03/12/98

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Shift Burden of Proof/"Taxpayer's Rights Protection Act of 1998"

____	DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.
____	AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
X	AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended February 6, 1998.
____	FURTHER AMENDMENTS NECESSARY.
____	DEPARTMENT POSITION CHANGED TO ________________________.
X	REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED February 6, 1998, STILL APPLIES.
____	OTHER - See comments below.

SUMMARY OF BILL

This bill would declare legislative intent to conform to federal law relating to shifting the burden of proof in connection with taxes paid by California income tax taxpayers. (See Burden of Proof on page 2.)

Under the Revenue and Taxation Code (R&TC), this bill would do the following:

- Allow a taxpayer, with respect to taxes or fees administered by the Board of Equalization (BOE), to maintain a suit or proceeding in any court upon payment of an unspecified percentage of the amount in dispute. This provision would not impact the programs administered by the department.
- Provide that the BOE would have the burden of proof, applying the clear and convincing evidence standard, to show taxpayer intent to evade or fraud penalties. This provision does not impact the programs administered by the department.
- Provide that the Franchise Tax Board (FTB) would have the burden of proof, applying the clear and convincing evidence standard, to show taxpayer intent to evade or fraud penalties. (See Burden of Proof on page 2.)

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O	____ S ____ O	
____ SA ____ OUA	____ SA ____ OUA	Position Approved ____
____ N ____ NP	____ N ____ NP	Position Disapproved ____
____ NA ____ NAR	____ NA ____ NAR	Position Noted ____
___X_____ PENDING	DEFER TO ____________	
Department/Legislative Director Date	Agency Secretary Date	By: Date:
G. Alan Hunter 3/24/98		

LSB TEMPLATE (rev. 01-96)

- Require FTB to provide taxpayers, upon their request, with itemized receipts proportionately allocating, in dollars, the taxpayer's total tax payments among specified major expenditure categories. (The department's prior analysis of this provision still applies, see Itemized Receipt in the analysis of the bill as amended on February 6, 1998.)

- Allow a taxpayer to make payment of taxes by making a deposit in the nature of a cash bond to stop the running of interest and still preserve the taxpayer's right to file a claim for refund. (The department's prior analysis of this provision still applies, see Payment of Cash Bonds in the analysis of the bill as amended on February 6, 1998.)

Under the Unemployment Insurance Code (UIC), this bill would do the following:

- Provide that interest shall not be charged on penalties and would make related clarifying changes. (Although this provision would not impact the programs administered by the department, a discussion was provided in a prior analysis, see UIC/Interest on Penalties in the analysis of the bill as amended on February 6, 1998.)

- Amend the due process provisions to allow taxpayers to make partial payments and remain in the appeals process. This provision would not impact the programs administered by the department.

SUMMARY OF AMENDMENT

The March 12, 1998, amendments added a provision to allow taxpayers, with respect to taxes and fees administered by the BOE (the reference to the "board" applies only to the BOE), to pay an unspecified percentage of amounts in dispute and bring suit for refund. This provision would not impact the programs administered by the department.

The March 12, 1998, amendments also significantly changed the burden of proof provisions of the bill. Except for the burden of proof discussion, the analysis of the bill as amended February 6, 1998, still applies. The burden of proof discussions provided in the analyses of the bill as amended February 6, 1998, and as amended on March 2, 1998, are replaced with the following. The Franchise Tax Board's position on this bill is pending.

1. Burden of Proof

EFFECTIVE DATE

This provision would be operative January 1, 1999.

BACKGROUND

H.R. 2676, which is known as the "Internal Revenue Service Restructuring and Reform Act of 1997," contains 31 provisions under the title Taxpayer Protection and Rights. One such provision would shift the burden of proof in court proceedings from the taxpayer to the Internal Revenue Service (IRS). Under the proposed federal bill, the burden of proof shift would not apply to partnerships, corporations or trusts whose net worth is more than $7 million. In addition, the burden of proof shift would apply only if the taxpayer has fully cooperated with the IRS, “including providing, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within the control of the taxpayer, as reasonably requested.” The provision would apply to court proceedings arising in connection with examinations commencing after the date of the enactment of the Act.

This proposed legislation passed the House of Representatives on November 5, 1997. The Senate is expected to hold hearings early this year and produce its own version of IRS restructuring legislation by spring.

SPECIFIC FINDINGS

Current federal and state laws impose a civil fraud penalty for fraudulent underpayment of tax required to be shown on a return. The penalty is equal to 75% of the portion of the underpayment attributable to fraud. The fraud penalty can be imposed only if a return is filed by the taxpayer. The penalty is not imposed where the taxpayer shows reasonable cause for the underpayment and that he or she acted in good faith. Imposition of the fraud penalty on any part of an underpayment precludes imposition of any of the accuracy-related penalties on that same part.

Case law has placed the burden of proof, applying the clear and convincing evidence standard, on the taxing agency (IRS or FTB) for the civil fraud penalty.

Current state law imposes civil and criminal penalties for certain offenses, with or without intent to evade. These offenses include failure to file returns, failure to furnish information, false or fraudulent returns or statements, and aiding abetting, or counseling others to evade tax by not filing returns or information or by making false or fraudulent returns or information.

This penalty must be recovered in court. Although the law allows for civil action, the penalty is usually pursued as a criminal matter where the violation is a misdemeanor punishable by imprisonment not to exceed one year and a fine. In a criminal proceeding the burden of proof is on the prosecution (the department), and the standard of proof is beyond a reasonable doubt.

Under current federal law, taxpayers may be required to keep certain records and may be requested by the IRS to substantiate items reflected on their federal income tax returns. The IRS may issue a deficiency assessment based on: taxpayers’ inability to substantiate items reflected on their income tax return or third party information returns (W-2s, 1099s, etc.). If collection is determined by IRS to be in jeopardy, a jeopardy assessment is issued, whereby the amount of the deficiency is immediately due and payable.

Taxpayers may protest deficiency assessments or jeopardy assessments to the IRS. In the event the IRS denies the protest, under the federal appeals system, the taxpayer may either: (1) appeal the assessment to the Tax Court (which has a small claims division for amounts of $10,000 or less), or (2) pay the assessment and file a claim for refund with the IRS. Once the IRS denies the claim, the taxpayer may file suit for refund in an U.S. District Court or the U.S. Court of Claims.

In these reviews, a rebuttable presumption exists that the IRS's determination of tax liability is correct. Taxpayers have the burden of proving that the IRS's action was incorrect and establishing the merits of their claims by a preponderance of the evidence. This review is an independent judicial review by a trial court upon evidence submitted by the parties. Both the taxpayer and the IRS can bring actions in appellate courts to appeal final adverse determinations, except small claims division determinations, which are binding.

Under current state law, all taxpayers may be requested by the FTB to furnish substantiation of the items reflected on their income tax returns and certain taxpayers (i.e., water's-edge taxpayers) may be required to keep certain records. The FTB may issue a proposed deficiency assessment based on: taxpayers' inability to substantiate items reflected on their income tax return, third-party information returns (W-2s, 1099s, etc.), or information FTB receives from IRS. In the rare instance that collection is determined by FTB to be in jeopardy, a jeopardy assessment is issued whereby the amount of the deficiency is immediately due and payable.

If the taxpayer disputes an assessment, the taxpayer may (1) protest the proposed deficiency assessment or jeopardy assessment by filing a written "protest" with the FTB, or (2) pay the assessment and file a claim for refund (in which case the taxpayer may proceed to the Board of Equalization [BOE] or Superior Court if the claim is denied or no action is taken on the claim within six months).

The taxpayer's administrative forum for appealing an adverse FTB action is the BOE. The BOE is the first independent administrative level of review of an FTB action. During the appeal process, the BOE makes an independent determination of the action. The BOE accepts evidence submitted by the taxpayer and, if requested by the taxpayer, grants an oral hearing on the matter. In the independent review by BOE, there is a rebuttable presumption that the FTB action was correct. Hence, taxpayers have the burden of producing evidence to show that the FTB's action was incorrect and establishing the merits of their position by a preponderance of the evidence.

In the event of a final adverse BOE decision the taxpayer's recourse is to pay the amount due and bring an action for refund against the state in Superior Court. With residency matters payment is not required. In litigation, as with appeals, there is a rebuttable presumption that the FTB action was correct. In addition, a taxpayer in a suit for refund is the plaintiff. Consequently, taxpayers (like plaintiffs in other civil actions) have the burden of proving that the FTB's action was incorrect and establishing the merits of their claims by a preponderance of the evidence.

This provision would codify existing case law by specifying that in substantiating civil penalties for fraud (Section 19164), FTB would have the burden of proof, by clear and convincing evidence, in any court or administrative tax proceeding or in any evaluation of tax compliance with respect to factual, or legal issues relevant to ascertaining the liability of a taxpayer.

This provision would change existing law with regard to the standard of proof in a criminal proceeding for matters involving intent to evade taxes or fraud.

This provision would not be construed to supersede or limit the application of any legal requirement to substantiate any item, and unreasonable search or access to records in violation of the United States Constitution, California Constitution or any other law would be prohibited.

This provision also would declare legislative intent to conform to federal law relating to shifting the burden of proof in connection with taxes paid by California income tax taxpayers.

Policy Considerations

This provision would raise the following policy considerations.

- This provision would clarify the burden of proof regarding civil fraud penalties by codifying existing case law.

- This provision would appear to reduce the burden of proof regarding criminal fraud and intent to evade penalties from the “beyond a reasonable doubt” standard to “clear and convincing evidence” standard and may conflict with constitutional principles of due process.

- If federal legislation shifting the burden of proof is enacted and is conformed to by the state, every assessment made by the department could be impacted. In fact, shifting the burden of proof could result in reduced compliance and more intrusive audits.

  The Tax Executives Institute, representing approximately 5,000 corporate tax professionals, indicated in a letter to the Congressional Ways and Means Committee Chair that its organization fears that shifting the burden of proof would result in a much more intrusive IRS.

  Because wage earners’ and retired individuals’ records are supplied to the IRS and FTB by employers and others, shifting the burden of proof to taxing agencies in these instances would be somewhat insignificant. However, businesses dealing primarily with cash transactions, those in the “underground economy,” could benefit from a shift in the burden of proof. Such taxpayers may be more likely to take aggressive positions on returns and contest audit results. Audits would have to be more thorough to obtain the proof necessary to sustain audit findings.

- On the other hand, for many taxpayers the income tax system is their only contact with government and the large bureaucracy frightens them. Thus, they may not protest or appeal audit findings even if they believe them incorrect. Proponents believe that shifting the burden of proof would create a better balance between government and taxpayers.

- Generally in civil cases the burden of proof is on the plaintiff, the party seeking corrective action. The taxpayer is the plaintiff in all California Superior Court actions. In addition, for tax cases the taxpayer has control of the records and documents necessary to ascertain the taxpayer’s tax liability.

- Currently, the taxpayer is asked to substantiate the amounts reported on the return, and deductions are considered to be a matter of legislative grace. The Internal Revenue Code (IRC) and R&TC have few statutes that specifically require substantiation; the requirement to substantiate an item rests mainly in case law regarding burden of proof.

Implementation Considerations

According to the author's staff, the intent of Section 4 of the bill is to codify the current policy that FTB has the burden of proof, by clear and convincing evidence, for civil fraud penalties (imposed pursuant to Section 19164). However, the language of Section 4 appears to reduce the standard of the burden of proof in certain criminal matters and to shift the burden of proof to the department with respect to any factual or legal issue relevant to ascertaining the liability of a taxpayer. If the bill is not amended to reflect the author's intent, the department would have additional implementation considerations.

This bill would declare legislative intent to conform to any federal legislation enacted that would shift the burden of proof. Departmental impact cannot be determined until such legislation is enacted. However, the following implementation concerns regarding the burden of proof are provided for consideration.

- One significant department workload is assessments based upon federal Revenue Agent Reports (changes made by the IRS to gross income or deductions reported on the federal return). Currently, such adjustments are presumed to be correct. Any legislation shifting the burden of proof should address whether the department would be required to prove that the changes made by the IRS to the federal return are correct.
- Currently, FTB generally retains taxpayer records for a period of three to four years and then destroys them, as authorized under R&TC Section 19530. Shifting the burden of proof to the department may require longer retention of records and increased costs for storage.
- Shifting the burden of proof could require FTB to engage in more extensive evidentiary gathering activities. This may require personnel additions to the audit and legal staff.

Technical Considerations

Amendment 1 would replace the term "board" with "Franchise Tax Board."

FISCAL IMPACT

Departmental Costs

Codifying case law regarding the burden of proof for fraud penalties would not significantly impact the department's costs.

The departmental costs associated with conforming to any federal legislation enacted to shift the burden of proof are unknown. The department's costs could increase, however, to the extent that additional supporting evidence would be required on all cases to support the state's position.

Tax Revenue Estimate

Codifying case law regarding the burden of proof for civil fraud penalties would not impact Personal Income Tax or Bank and Corporation Tax revenues.

Conforming to any federal legislation enacted to shift the burden of proof would result in unknown, but potentially significant, revenue losses.

Tax Revenue Discussion

The revenue loss for conforming to any federal legislation enacted to shift the burden of proof would be determined by those assessments that may be revised due to incomplete documentation to support the assessment and revenues lost from possible negative effects on voluntary compliance.

Revenue losses in any given year are unknown. It is not possible to determine the number of cases in which the outcome would be changed because of the shift in the burden of proof. It is not clear how the courts would define “cooperating taxpayer.”

The Joint Committee on Taxation in its revenue estimate of H.R. 2676 estimated that shifting the burden of proof would result in a cumulative revenue loss of $795 million for fiscal years 1998 to 2002. It has been expressed at the federal level that a negative revenue impact may result from reduced self-assessed reporting, which could have an effect on departmental audit programs.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 1631
As Amended March 12, 1998

AMENDMENT 1

On page 6, line 6, strikeout "board" and insert:

Franchise Tax Board